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March 29, 2004

VIA HAND-DELIVERY

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, MA 02110

Re: D.T.E. 04-01 - Investigation Regarding the Assignment of Interstate Pipeline Capacity

Dear Secretary Cottrell:

Enclosed for filing in the above-referenced docket are the **Reply Comments of Bay State Gas Company** ("Bay State"). Bay State is filing these Reply Comments in response to Initial Comments submitted in this docket by various interested parties and pursuant to the Order issued on January 12, 2004, by the Department of Telecommunications and Energy ("Department"), which established the procedural schedule for comments.

Please do not hesitate to contact me with any questions. Kindly date-stamp a copy of this letter for our files and return it to us in the enclosed envelope.

Thank you for your attention to this matter.

Very truly yours,

Patricia M. French / SBK

Patricia M. French

cc: Caroline M. Bulger, Hearing Officer (1 copy)
Andreas Thanos, Assistant Director, Gas Division (4 copies)

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

REPLY COMMENTS

OF

BAY STATE GAS COMPANY

D.T.E. 04-01

MARCH 29, 2004

I. Introduction

In its order issued January 12, 2004, the Department of Telecommunications and Energy ("Department") sought comments on whether the upstream capacity market is sufficiently competitive to warrant the Department to modify its currently-approved mandatory approach to capacity assignment. See, *Order Opening Investigation Regarding the Assignment of Interstate Pipeline Capacity*, D.T.E. 04-01 (Jan. 12, 2004) ("Order"). On March 1, 2004, pursuant to the schedule established by the Department, Bay State Gas Company ("Bay State"), among others, filed its initial comments ("Initial Comments"). Bay State respectfully submits this Reply to the comments filed by other parties.

In filing this Reply, Bay State has focused on the most prominent issues presented by Amerada Hess Corp. ("Hess") and Energy East Solutions, Inc. ("Energy East"). The Department should not interpret Bay State's silence on any issue or position offered by these or any other party, which is not specifically addressed herein, as agreement, assent or acquiescence.

II. Summary of Bay State's Initial Comments

Bay State's Initial Comments recommended that the Department continue its existing mandatory capacity assignment policy and continue to require local distribution companies ("LDCs") to plan and to procure adequate upstream capacity to ensure the reliability of service to customers. Bay State reviewed the relevant changes in wholesale markets since the Department adopted its initial mandatory capacity assignment policy in 1999, as well as its own experience as an early proponent of transportation service on behalf of its customers. Bay State's recommendations in its Initial Comments were based, in part, on the many indications that a lack of competition in upstream capacity markets serving Massachusetts continues to persist and is accompanied by a financial instability of certain suppliers serving Bay State customers. In sum, while the Department found in D.T.E. 98-32B *(*the *"1999 Capacity Order")* that upstream markets must be sufficiently competitive in order for it to modify the existing obligation for LDCs to acquire capacity to maintain reliability, such conditions simply do not exist today.

III. BAY STATE RESPONSE

Bay State's Reply addresses four issues: Partial Voluntary Assignment of Capacity; Path vs. Slice-of-System Assignment; Monthly Releases; and, the Scope of this Proceeding.

A. Partial Voluntary Assignment

In its comments, Hess advocated two specific programs by which marketers could "substitute" the capacity assigned from LDCs with capacity purchased by the marketers directly. Hess Comments at 19, 21. Both programs promote capacity substitution and introduce voluntary capacity assignment for existing, non-grandfathered transportation customers. However, the two programs operate differently from one another. The first program proposes to allow marketers to avert assignment of capacity on each occasion that an LDC capacity contract is renewed for an amount equal to the proportion of deliverability represented by that contract. See, Hess Comments at 19-20. The second program proposes to allow marketers to turn back their capacity to the LDC any time that the LDC would be obtaining incremental capacity to meet future growth. See, Hess Comments at 21-23.

The capacity substitution programs proposed by Hess would bring a significant degree of voluntary assignment of capacity into the market, and would remake the current market structure, over a short time period. In Bay State's view, the impact of instituting one or both of these programs is the equivalent of Hess advocating a rapid and direct transition to voluntary assignment. The Department should be very cautious, considering that Hess' approach amounts to a backdoor attempt to bring about a significant degree of voluntary assignment.

When Bay State initially reviewed Hess' proposal, it was concerned that the implementation of either of Hess' voluntary capacity programs would dramatically increase the portion of transportation load that would not have assigned LDC capacity. In order to determine the degree to which this would occur, Bay State analyzed the impact of Hess' proposals on its system. Today, Bay State has approximately 439,000 Dth of assignable peak day deliverability to serve sales and non-grandfathered transportation customers. The current design day load of the non-grandfathered customers is 31,178 Dth or approximately 7.1% of the total. Approximately 11.6% of Bay State's peak day deliverability would come up for renewal over the next five years. Under Hess' proposal, marketers would have the option to reduce their current assignment of capacity from the LDC (in this case, Bay State) by this amount, which would reduce their assignment from the existing level of 16,100 Dth to 14,232 Dth on Bay State's system. In addition, Bay State anticipates incremental capacity needs of approximately 28,228 Dth over the next five-year term, an estimate consistent with and based on the five-year forecast reflected in the Company's most recent IRP filing, DTE 02-75. Because the proposal advocates that Bay State must offer marketers the right to turn back existing capacity rather than acquiring needed incremental upstream capacity, marketers could further reduce their capacity assignment by an additional 2,004 Dth to 12,228 Dth. The net result is that over a relatively short five-year period, Bay State's non-grandfathered customers would only be assigned 76 % of their capacity requirements from the LDC. The rest would be entirely voluntary on the part of marketers.

Hess appears unconcerned about the attendant risks when significant portions of LDC load are not subject to LDC capacity planning and acquisition. Moreover, contrary to Bay State's understanding and observations that were described in its Initial Comments, while Hess claims that wholesale market conditions have "clearly" improved since 1998,[1] Hess fails to account for the impact on the market of the substantial use of natural gas to fire incremental electric generation in the region that, in Bay State's view, has offset the benefits of additional deliverability.

In addition to failing to describe how the markets could sustain voluntary capacity assignment, the Hess proposals present significant risk because neither LDCs nor the Department would be able to review and confirm the terms of the capacity contracts acquired by marketers. Nor would the LDCs have the means to reliably serve customers that migrate back to utility sales service, because, even if marketers elect to acquire capacity that was previously held by Bay State, Bay State would no longer have contractual control over that capacity.

This is not mere speculation. Bay State would have been exposed to a dangerous capacity shortfall had Hess' proposals been in effect during the past few years. As described in Bay State's Initial Comments, substantial numbers of non-grandfathered customers migrated back to sales service as their marketers exited retail markets, leaving Bay State to deal with a potential capacity shortfall. By fortune, Bay State was simultaneously seeking to renew previously-held Tennessee capacity and in addition, was able to secure other incremental resources. Had Bay State been required to allow non-grandfathered customers to turn back

[1] Hess Comments at 18.

capacity instead of renewing its Tennessee capacity, Bay State believes that a deliverability problem would have been created on its system.

At the minimum, were Hess' proposed programs adopted by the Department, customers would be exposed to greater price volatility were the LDC required to obtain incremental capacity on short notice. However, the worst case scenario would occur if the LDC were unable to continue to serve its existing residential and C&I customers on a firm basis.

Hess has simply failed to demonstrate that upstream capacity markets are sufficiently competitive to support voluntary assignment and produce benefits for all customers. Bay State believes the Department should reject Hess' proposals because they seek to introduce voluntary assignment prematurely at a time when capacity markets are not workably competitive.

B. Path vs. Slice-of-System Assignment

When the Department adopted mandatory capacity assignment, it also required capacity to be assigned on a slice-of-system basis rather than a path basis. Capacity Assignment, D.T.E. 98-32-B at 35. Under the slice-of-system approach, a pro rata share of each upstream capacity contract is assigned to each marketer based on the size of their customer pool. Id. Under a path approach, capacity is assigned on a limited number of paths. The potential for cost differences on the different paths complicates the path assignment approach. The Department opted for a slice-of-system approach because it allocated capacity costs equitably. Id.

Hess and Energy East each propose the Department modify existing slice-of-system assignment to a path assignment. Hess Comments at 6; Energy East Comments at 6-8. They recommend that the fixed cost differences on the paths be credited or surcharged to suppliers as a means of addressing potential cost inequities. Hess Comments at 7; Energy East Comments at 8.

As a general matter, Bay State is not opposed to instituting a path assignment approach. However, the looming problem of cost inequities goes beyond potential fixed cost differences among various capacity paths. In Bay State's view, limiting the credit or surcharge to fixed cost differences as suggested by Hess and Energy East fails to account for sizeable commodity cost differentials that make some capacity paths more economical than others. See, Hess Comments at 7; Energy East Comments at 8. In particular, the reason a mere limiting of fixed costs differentials fails is because it is insufficient: the basis differentials at receipt points on different paths and the commodity and fuel charges on different paths contribute to cost differences that must be accounted for in addition to the fixed cost differences.

In order to understand the potential magnitude of the non-fixed cost differentials on various pipeline paths, the Department need only consider pricing differences during the cold snap during January of this year (2004). During the month of January, Bay State purchased Gulf Coast gas delivered via Tennessee and Algonquin at an average commodity price of $6.67 per Dth. During this same period, Bay State purchased Canadian gas at Waddington and delivered via Iroquois at an average price of $8.07 per Dth. The significant price differential occurred because Iroquois is not a liquid market center and does not have a first-of-the-month index price reference for monthly purchases. Price differentials of different magnitudes exist throughout the year. Because of this, Iroquois is subject to significant pricing variations during periods of high demand. If these additional costs were not reflected in the capacity assigned under a path assignment approach, Bay State's firm customers would bear an inappropriate weight of the cost and subsidize competitive services. Moreover, transportation customers would not be seeing the true cost/value of the services rendered to them.

Unfortunately, accounting for basis differentials and fuel differences among paths is very complex because they are affected by the absolute levels of NYMEX prices and regional prices, that can vary widely and are not known in advance. Substantial analysis of these differences, at increased administrative cost, would be required to ensure fairness and to provide marketers with the certainty regarding the charges that they will be required to pay in advance. If the Department were to adopt a path approach, it would need to establish a reasonable process for determining the economic differences among paths that takes into consideration fixed and variable costs including expected basis differentials. In addition, this process would need to be reasonably consistent across Massachusetts LDCs, which have capacity on many of the same pipeline systems, but at the same time must also account for utility-specific portfolio issues that do exist. Lastly, any process defined by the Department would incorporate a fair means of resolving differences of opinion regarding the economic value of various paths that could not be agreed upon by the interested parties including marketers and LDCs.

A final point related to potential inequities arising from a path approach is that suppliers who are first to enter the market and choose their paths early could very well be acquiring the most desirable paths for suppliers serving customers in this region. By suppliers "cherry-picking" the most desirable paths early, those suppliers who enter the market later, as well as the LDCs' remaining default customers, would be disadvantaged, considering that at some point in time only the less desirable paths would remain available.

C. Monthly Releases

In its comments, Hess recommends changes to the method currently used to adjust capacity releases to accommodate increases or decreases to the size of individual marketer pools.

Hess Comments at 7-8. The existing method (developed by the parties to D.T.E. 98-32-B and reflected in the Model Terms and Conditions[2]) calls for LDCs to recall and re-release capacity each month that there is a change in the size of a marketer's pool. See, e.g., Bay State's Tariffs at Section 13.7. Hess' proposed change would assign a single baseload level of capacity for an entire year and proposes monthly recalls and re-releases be used to address only the incremental changes in pool requirements. Hess Comments at 7-8.

At first blush, Bay State is not opposed to modifying this aspect of the Model Terms and Conditions, and is willing to discuss the development of appropriate details using the New York method as a discussion starting point, if the Department determines it is appropriate for Massachusetts markets. However, it should be noted that this new method will increase the number of contracts that are assigned to marketers, which Hess commented was undesirable earlier in its comments when it advocated a change to path assignment. Because this approach would increase the number of contracts to be assigned to marketers, this change is likely to not be the preference of other marketers.

D. Scope of Proceeding

A number of commenters made proposals beyond the scope of the investigation initiated by the Department in this proceeding. Many of these issues are simply far afield of matters germane to the Department's capacity assignment investigation, while others would be best addressed by the parties informally rather than through a formal proceeding such as this.[3] One

[2] The Model Terms and Conditions implementing the Department's 1999 Capacity Order were adopted by the Department in D.T.E. 98-32D.

[3] Energy East's comments raise operational issues that may be commercially important to Energy East but that are largely associated with matters not reflected in LDC tariffs. To the extent that any of the operational issues raised by Energy East pertain to its relationship with Bay State, the Company is willing to work with Energy East to

such issue is Hess' recommendation of a 60% reduction in penalties applicable during OFO periods. Hess Comments at 9. However, the penalty structure is an important component of ensuring reliability when marketers control capacity needed to provide service to distribution customers. This is particularly true during OFO periods when reliability is critical and market indices are subject to fluctuations up and down. As a substantive matter, if the Department were to entertain it in this docket, the proposed reduction in the applicable OFO period would result in a substantial reduction in protection for reliability for LDCs and should be rejected by the Department. More importantly, however, Hess' recommended reduction in the applicable OFO period was not demonstrated to relate to the competitiveness of upstream capacity markets and therefore is beyond the scope of this proceeding. Hess, like others who raised issues outside the scope, is free to pursue its concerns in a different proceeding that it can initiate, in which all issues related to its proposal can be addressed.

IV. CONCLUSION

Wherefore, for all the reasons set forth in this Reply and in its Initial Comments, Bay State Gas Company respectfully requests that the Department of Telecommunications and Energy affirm its order in D.T.E. 98-32-B and continue to require mandatory capacity assignment until it is demonstrated that upstream capacity markets are sufficiently competitive.

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reach a mutually agreeable solution on an informal basis. Other issues similar to those raised by Energy East are typically resolved in this manner.

Respectfully submitted,

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DATED: March 29, 2004